No. 10236

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

SAM KLEINMAN,

Appellant,

vs.

PAUL W. SAMPSELL, Trustee in Bankruptcy of the Estate of Abraham Zemansky, David Zemansky and Sol Zemansky, doing business under the fictitious names and styles of PROVIDENT LOAN ASSOCIATION and STATE LOAN OFFICE, BANKRUPTS,

Appellee.

BRIEF OF APPELLEE.

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At the time of the execution of the agreement bearing date of February 24th, on which claim for security was based, the Zemanskys were insolvent, and that condition continued down to the date of bankruptcy, and appellant Kleinman knew, or had reasonable cause to believe that a condition of insolvency existed and that his alleged security would constitute a preference over other creditors of the bankrupt 18

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Appellee.

BRIEF OF APPELLEE.

The record before the court in the case at bar discloses an extremely clever attempt on the part of the Appellant Sam Kleinman and his son-in-law Edward Dienstag to circumvent long-established laws of the State of California with regard to the transfer and hypothecation of personal property in fraud of creditors, and to likewise circumvent the plain provisions of §60-a of the National Bankruptcy Act (11 USCA, §96-a) by procuring for the Appellant Sam Kleinman, security for an obligation in excess of $100,000.00 due Appellant Kleinman in a manner which would hinder, delay, or defraud other creditors of the bankrupt, Zemansky Brothers, and which

would procure a secret lien on personal property in favor of Appellant Kleinman without any delivery either immediate or otherwise of said personal property to Appellant.

Before going into a discussion of the case, or of Appellant's brief, we shall first set out the statutory provisions applicable to the case at bar as they existed at the time of the interesting transaction which has been annulled by both lower courts, the referee and the district judge. At the time of the transaction involved here, the month of February, 1939, §3440 of the Civil Code of California, in so far as material here, read as follows:

> "Every transfer of personal property, other than a thing in action, * * * and every lien thereon, other than a mortgage, when allowed by law, * * * is conclusively presumed if made by a person having at the time the possession or control of the property, and not accompanied by an immediate delivery, and followed by an actual and continued change of possession of the things transferred, to be fraudulent and therefore void, against those who are his creditors while he remains in possession, and the successors in interest of such creditors and against any persons on whom his estate devolves in trust for the benefit of others than himself, and against purchasers or incumbrancers in good faith subsequent to the transfer * * *."

Section 2986 of the Civil Code of California, read as follows:

> "Pledge is a deposit of personal property by way of security for the performance of another act."

Section 2987 of the Civil Code, read as follows:

> "Every contract by which the possession of personal property is transferred, as security only, is to be deemed a pledge."

Section 2988 of the Civil Code of California, read as follows:

> "Except as otherwise provided in Chapter III-A of Title XIV of Part IV of Division Third of the Civil Code, the lien of a pledge is dependent upon possession, and no pledge is valid until the property pledged is delivered to the pledgee, or to a pledgeholder, as hereafter prescribed."

The portions of the Civil Code referred to in §2988 deal with mortgages of personal property and pledges.

Section 2990 of the Civil Code reads as follows:

> "One who has a lien upon property may pledge it to the extent of his lien."

Section 60-a of the National Bankruptcy Act (11 USCA, §96-a) reads as follows:

> "A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition in bankruptcy, or of the original petition under Chapter X, XI, XII or XIII of this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class. For the purposes of subdivisions a

and b of this section, a transfer shall be deemed to have been made at the time when it became so far perfected that no *bona fide* purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and if such transfer is not so perfected prior to the filing of the petition in bankruptcy or of the original petition under Chapter X, XI, XII or XIII of this Act, it shall be deemed to have been made immediately before bankruptcy."

The word "transfer" as used in §60-a of the National Bankruptcy Act is defined in §1, subdivision (30) of the Act (11 USCA, §1, subdv. 30, as amended in 1938), as

> " 'Transfer' shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise."

Section 60-b of the National Bankruptcy Act (11 USCA, §96-b), in so far as material here, reads as follows:

> "Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."

Section 60-c of the National Bankruptcy Act (11 USCA, §96-c), reads as follows:

> "If a creditor has been preferred, and afterward in good faith gives the debtor further credit *without security of any kind* for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him." (Italics ours.)

Section 70-a of the National Bankruptcy Act (11 USCA, §110-a), reads as follows:

> "The trustee of the estate of a bankrupt * * * shall * * * be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition in bankruptcy or of the original petition proposing an arrangement or plan under this Act, except in so far as it is to property which is held to be exempt, to all * * * (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered."

Section 70-e of the National Bankruptcy Act (11 USCA, §110-e), reads as follows:

> "(1) A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this Act which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this Act, shall be null and void as against the trustee of such debtor."

The preference attempted by the parties thereto in favor of Appellant Kleinman consisted in an attempted transfer, within four months preceding the filing of the petition in bankruptcy, of a large number of pawns to Kleinman, who for a long time had been an employee of the bankrupts in their pawn shop, for the purpose of securing a long past due antecedent debt in excess of $100,000.00, without delivery of the pawns to Kleinman.

Section 3 of the California Pawn Broker's Act enacted July 15, 1935, Statutes of 1935, Chapter 538, page 1613 *et seq.*, reads as follows:

> "Every pawnbroker shall retain in his possession every article pledged to him, except clothing, wearing apparel, furs, trunks, and suit cases, and articles of similar character, for a period of one year after the last date fixed by his loan contract for redemption. He shall keep such excepted articles for a period of six months after the last date fixed for redemption by his loan contract.
>
> "The pledgor or his assigns, may redeem the articles at any time during such period. If such article is not redeemed within the period thus allowed, the pawnbroker shall at the end of that period become vested with all right, title and interest of the pledgor or his assigns therein, to hold and dispose of as his own property. All provisions of law relating to pledges and foreclosure of pledges in conflict with this Act shall not apply to pledges with pawnbrokers under this Act. It shall be a misdemeanor for any pawnbroker to violate any provision of this section."

The Questions Involved.

From the viewpoint of the Appellee there are just two questions involved, one of law and the other of fact, both of which were decided by the two lower courts adversely to the Appellant. An affirmance by this court of the lower court on either of the questions involved will sustain the order of the referee as affirmed by the District Court. The question of law involved, from our viewpoint, is as follows:

1. Is it possible in California, under the laws as they now exist and as they existed in February, 1939, for a debtor to give security to a creditor which would be valid as against other creditors of the debtor, by attempting to hypothecate personal property in the possession of the debtor, in favor of such creditor, without an immediate delivery followed by an actual and continued change of possession of the personal property or the placing thereon of a chattel mortgage duly executed and recorded in accordance with the provisions of §2957 of the California Civil Code?

2. Assuming, but by no means conceding that such security can be validly given in the State of California, as was attempted to be given here, within four months preceding the filing of the petition by Zemansky Brothers, do the facts and circumstances set forth in the record before the

COURT JUSTIFY THE FINDING OF THE REFEREE, AFFIRMED BY THE DISTRICT COURT ON REVIEW, THAT THE BANKRUPTS WERE INSOLVENT AND THAT THE APPELLANT HERE KNEW, OR HAD REASONABLE CAUSE TO BELIEVE THAT THEY WERE INSOLVENT AT THE TIME THE SCHEME WAS PUT INTO OPERATION TO SECURE KLEINMAN, AN EMPLOYEE FOR SEVERAL YEARS, OF THE BANKRUPTS, PREFERENTIALLY AND TO THE DETRIMENT OF THE OTHER CREDITORS OF THE ZEMANSKY COPARTNERSHIP, BANKRUPT?

We submit that the latter question was one of pure fact resolved against the Appellant in both of the lower courts.

Argument, Points and Authorities.

In so far as the actual mechanics of the transaction are concerned little dispute exists between the parties to this appeal. Summarized in its briefest manner, Kleinman was apparently a wealthy man, able to lend out large sums of money and anxious to obtain an unusually high rate of interest. It is commonly known that six and seven per cent, or even less, is the usual rate of interest asked on large loans of money where the loan is made to a solvent concern, without security. We have no such picture here. Prior to the interesting transaction entered into in February of 1939 Kleinman held no security for the loans which he had made to this partnership which he now contends he believed to be thoroughly sound and solvent. These loans were in excess of $100,000.00, as was testified to by Sol Zemansky. [Tr. p. 185.] The interest charged the bankrupts by Appellant from 1933 down to February, 1939, at the time he took his security from the Zemanskys, was in most instances twelve per cent per annum. [Testimony of Sol Zemansky, Tr. p. 99.]

Kleinman became an employee of the Provident Loan Association (the bankrupt copartnership), in 1935, his duties being to dispose of merchandise consisting of foreclosed pledges. [Tr. pp. 99, 100.] He received a salary of $75.00 per week and one per cent on each sale, from the inception of his employment [Tr. p. 100], down to a time when the bankrupts became sufficiently financially involved that his salary was reduced from $75.00 to $50.00

per week, under the pretext that he did not want to spend so much time around the bankrupt's place of business. [Tr. pp. 239, 240.] He started to assist in the Loan Department of the bankrupt in 1936 or 1937, at a time when the disposition of jewelry, as a result of unredeemed purchases, became rather slack. [Tr. p. 101.] In the latter part of 1938 or the early part of 1939 the Appellant first commenced talking to the Zemanskys about security. He said he wanted to go away and rest up and desired to have his money secured while he was away. However, he continued to come up to the Provident Loan Association office every day regardless of the pressing necessity for a rest. [Tr. pp. 102, 103.] Sol Zemansky told him at that time that he was unable to give him security for his money. [Tr. p. 103.] Appellant then apparently demanded payment of a part of the money that was owing to him [Tr. p. 103.] Sol Zemansky apparently told him that the bankrupt was unable to pay him any money. Appellant then suggested "turning over loans" to him for the amount of money the Zemanskys owed him, meaning loans which the Zemanskys had made to customers who had come into their pawnshop. [Tr. p. 104.] Apparently no inquiry was made by Appellant Kleinman at the time of this demand as to indebtednesses owing to other creditors until after he had obtained his alleged security. [Tr. pp. 104, 105.] Sol Zemansky with whom the transaction appears to have been negotiated, can recall no inquiries of that nature prior to the taking of the alleged security by him. [Tr. p. 105.] Even as late as the end of 1938 Kleinman had never asked the Zemanskys for any security for the large amount of money he had loaned to them. [See Testimony of Sam Kleinman, Tr. p. 393.] Apparently he had been content with his 12% per annum interest.

In January, 1939, shortly before an attachment was run on Zemanskys' business Appellant Kleinman went to San Francisco to see his son-in-law, Mr. Dienstag and his daughter, and told Mr. Dienstag that he had left the employ of the Zemanskys. [Tr. p. 394.] He returned to Los Angeles, and according to his version [Tr. p. 395], he had a most casual conversation with Sol Zemansky regarding giving him security for the large indebtedness owing to him. According to his version of the conversation he merely said:

> "Sol, I am no more employed by you and how would you like to give me—you know, I left you; how would you like to give me security for my money?" Sol says, 'Why, Sam, anything I can do for you I will be glad to do it for you, give you security if you want it; of course, I don't like to have you leave me, but if you want security I will be glad to give it to you.'
>
> Q. Now, when you had that conversation with Mr. Zemansky, had you already left the employ of the Provident Loan Association? A. Yes, sir." [Tr. p. 395.]

Kleinman never discussed the question of obtaining security with Sol Zemansky from then on. [Tr. p. 397.] From then on all negotiations were had with Kleinman's attorney, his son-in-law Mr. Dienstag. [Tr. pp. 397, 398.] According to Kleinman he did not ask Zemansky on several occasions for security, and on the one occasion that he did ask for security Sol Zemansky did not even tell him that he would have to take the matter up with his brothers who were his partners. [Tr. pp. 397, 398.]

Mr. Dienstag came down from San Francisco to Los Angeles without being requested to do so by his father-

in-law the Appellant. [Tr. p. 399.] Apparently Appellant went back to San Francisco after speaking to Sol Zemansky about his suggestion that he be given security, and informed his attorney son-in-law of the conversation. [Tr. p. 399.] Mr. Dienstag came down to Los Angeles some time during the month of January and took up with Sol Zemansky the question of securing his father-in-law, notwithstanding the fact that Kleinman testified that he had not employed Mr. Dienstag as his attorney. [Tr. p. 400.] Mr. Zemansky told him that under the Pawnbrokers Law he would not be permitted to repledge pledges. [Tr. p. 401.] He showed him one of their pawn tickets with the statutory provisions on the back, and Mr. Dienstag asked Sol Zemansky to let him take one of the tickets so that he could "look into it." [Tr. p. 402.] According to Kleinman not much of anything was said at that time about taking security and Mr. Dienstag said he would go back to San Francisco and look into the law. [Tr. p. 402.] There was no discussion of any other kind of security ever had between Mr. Deinstag and the Zemanskys. [Tr. pp. 402, 403.] Mr. Dienstag came back to Los Angeles the first part of February and resumed the negotiations. [Tr. pp. 403, 404.] He conceded that the Zemanskys did not have the right to part with possession of any of the pawns of merchandise, but said that he "had a way where we can have security on the pawn tickets." [Tr. p. 405.]

Mr. Dienstag's approximation of the time when he first discussed the question of security with his father-in-law

was that the conversation occurred around the 10th, 11th, or 12th of February, 1939. [Tr. pp. 513, 514, 515.] He went back to San Francisco and returned to Los Angeles again on the 16th or 17th of February. [Tr. p. 515.] A second conversation with Sol Zemansky took place in the presence of Appellant. [Tr. p. 516.] He then proceeded to outline to Mr. Zemansky, in the presence of Appellant, his scheme for circumventing the plain provisions of the Pawnbroker's Act and Section 3440 of the Civil Code, whereby his father-in-law could be secretly secured with the valuable pledges as a basis for the security. [Tr. pp. 516, 517.] Mr. Zemansky very casually called Leo Kravitz, his loan clerk, and told him to pull out about one hundred thousand dollars worth of* *pledges* for Sam. [Tr. p. 517.] They went out to dinner, and after dinner returned to the Provident Loan Association office, opened the vault and brought out two steel boxes containing envelopes with serial numbers, with the amount owing on each pledge on each particular envelope. [Tr. p. 518.] The numbers and amounts were totaled up until about $107,000 worth of *pledges* had been selected.

The pledges thus selected were placed in three steel boxes marked K-1, K-2 and K-3 and put back in the bankrupt's vault where they had been before. [Tr. pp. 519, 520.]

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*NOTE: Where the word "pledges" is italicized the italics are ours. We are italicizing this word frequently to show the free use of the word "pledges" as having been assigned to Kleinman rather than the use of the words "pledge tickets."

A contract, which is in evidence here as Trustee's Exhibit No. 4 [Tr. pp. 110, *et seq.*] was then drawn up and the exhibit attached to it. [Tr. p. 520.] Kleinman signed the contract the next day. [Tr. p. 521.] When he and Mr. Dienstag got ready to have Sol Zemansky sign they learned that Sol had gone up north. Mr. Dienstag left for San Francisco that evening. He took the contract with him and contacted Sol Zemansky's hotel the next morning. [Tr. p. 521.] The day following he contacted Sol Zemansky personally, meeting him about three o'clock in the afternoon. The agreement and the promissory notes were then signed on February 24, 1939. [Tr. p. 522.] Mr. Kleinman arrived in San Francisco the following morning, February 25th [Tr. p. 523] and Sol Zemansky apparently had returned to Los Angeles. He called Kleinman on long distance telephone on February 27, 1939, two days after Kleinman arrived back in San Francisco. [Tr. p. 523.] Mr. Kleinman, accompanied by his son-in-law, Mr. Dienstag, hastily returned to Los Angeles the following morning by airplane and contacted the Zemanskys. [Tr. p. 524.] They were informed that the Zemanskys needed twenty-five or thirty thousand dollars, because the Simons (creditors of Zemansky) had placed an attachment on Zemansky's place of business and the Sheriff was sitting out in the hall. [Tr. p. 524.] An effort was then made to induce Judge Isaac Pacht, attorney for the attaching creditor, to release the attachment. [Tr. p. 527 *et seq.*] This resulted in a new agreement between Kleinman and the Zemanskys whereby pledges which had been

attempted to be hypothecated to Kleinman were withdrawn and rehypothecated to Simon, in order to procure the release of the attachment. [Tr. pp. 531, 532; also Tr. pp. 451, 452, 453, 454.] The pledges to be withdrawn, however, were to be replaced with other pledges. [Tr. p. 532.]

This agreement was arrived at by the following conversation, testified to by Mr. Dienstag at page 531 of the transcript:

> "Mr. Zemansky then turned to Sam and he said, 'Sam, why couldn't we give him a drawer of your *pledges* and get those numbers so this can be completed while Eddie is here;' and Sam turned to me and he said, 'Well, Ed., can we do that?' I said, 'Yes, as long as we replace them with other *pledges*.' Sol said, 'Well, Sam, is that all right?' Sam said, 'Ed is handling this; it is up to him.' I said, 'That will be all right, Sol, as long as you put the loan back, replace the *pledges* which you take.' Sol then called Mr. Leo Kravitz and told him to take a drawer of those *pledges* and get the numbers off a drawer of Kleinman's, and get the numbers right over to Mr. Ross, so that they could be put in the contract, and as soon as he had gotten the numbers over there to start selecting *pledges* to replace the *pledges* that were taken from the Kleinman drawer. And those numbers, I am not certain whether I took those numbers over to Mr. Ross or whether they were sent over there, but they got over there in a very short time, as soon as they were copied off the Kleinman tickets,

> that is, that box of *pledges,* and about 5 o'clock of that day Kravitz had finished selecting the new *pledges* for Kleinman and had given me the numbers, which I took over to my office here in Los Angeles and handed to Mr. Horn, I think it was, to have copies for me for the basis of a new contract." [Tr. pp. 531, 532.] (Italics ours.)

At the time money had started coming in redeeming *pledges* which had been assigned by the bankrupts to Kleinman, instead of turning it over to Kleinman in payment of the large obligation owing to him, Sol Zemansky suggesting relending it again. Kleinman agreed, after conferring with his son-in-law Mr. Dienstag, who said: "Any money that you give them must be loaned out on new *pledges.*" Mr. Zemansky said: "That is what we want it for; of course it will be loaned out on new *pledges.*" Mr. Dienstag said: "In addition to that, all of the *pledges* that come in the Provident will have to come to secure you." (Meaning Kleinman.) (Parenthetical matter ours.) Adding the significant statement, "These *pledges* coming in, they are going to be your security." I said, "If you are going to give them money, you get all of the *pledges* coming to you." [Tr. pp. 533, 534.]

Later on, about April 5, 1939, the Zemanskys were apparently encountering difficulty with another creditor, one Gans. Kleinman expressed surprise at the existence of this indebtedness, according to his testimony. [Tr. p. 459.] Another arrangement was entered into whereby some more of Kleinman's pledges were taken out to secure

Gans indebtedness in the sum of $12,000. [Tr. pp. 459, 460.]

Kleinman's pledges were all kept in the Zemanskys' vault. Kleinman never went into the vault or safe and could not tell of his own knowledge whether his pawns were kept segregated from others. [Tr. p. 490.] He excuses his failure to enter the vault, after taking a purported assignment of over $100,000 worth of pledges, at page 497 and 498 of the Transcript, on the ground that Kravitz had told him that he was more of a nuisance than a help. [Tr. p. 498.] The money that was taken in from customers in redemption of pledges went back into the bankrupt's business and was reloaned out the same as other money. [Tr. pp. 507, 107, 108, 363.]

Kleinman on occasion would give Abe Zemansky a check which would be cashed at the Union Bank, the currency handed over to Kleinman to apply on the note and then the currency put out in new loans. [Tr. p. 109.] When Kleinman handled the redemption of any pledges which had been purported to have been assigned to him, himself, the money went into the cash drawer just the same as when the redemption was handled by Kravitz or Sago, the loan clerks. [Tr. pp. 340, 341.]

Kleinman occasionally examined the cash drawer both before and after obtaining his alleged security. If he did not find any money in the cash drawer of this money lending institution he would say "Nicht gut," meaning "No good." [Tr. p. 341.]

At the Time of the Execution of the Agreement Bearing Date of February 24th, on Which Claim for Security Was Based, the Zemanskys Were Insolvent, and That Condition Continued Down to the Date of Bankruptcy, and Appellant Kleinman Knew, or Had Reasonable Cause to Believe That a Condition of Insolvency Existed and That His Alleged Security Would Constitute a Preference Over Other Creditors of the Bankrupt.

We shall address ourselves, first, to the question of whether or not the attempted assignment of these pledges to Kleinman was preferential, for the reason that if it was, it must fall, regardless of whether the assignment consisted of an assignment of pledge tickets or an assignment of tangible pawns.

The bankrupt copartnership and each of the partners filed Schedules in Bankruptcy which were received in evidence by reference as Trustee's Exhibit No. 7. [Tr. p. 186.] This exhibit was likewise before the District Court on review [Tr. p. 53] and is before this court in the amendment to the record proposed by Appellee. An examination of these Schedules, or their summary, shows a hopeless condition of insolvency. The partnership liabilities, secured and unsecured totaled the sum of $1,341,-698.66, according to the recapitulation of the original Schedules filed, together with the Amendment to Schedule of creditors which added the sum of $4,000.00 to the original indebtedness. This does not take into consideration the tax claims or warehouse rent, the amounts of which were unknown. The summary of the Schedule of all the assets of the bankrupt totals $390,556.24. The Schedule of individual assets of David Zemansky totals only $100.00, representing cash on hand less than $100.00;

Schedule of the individual assets of Sol Zemansky likewise totals $100.00, or less, represented by cash on hand. Abe Zemansky scheduled some assets, including insurance policies which, when added to the individual assets of his brothers and those of the copartnership brought the total assets available to the sum of $412,584.04, if our arithmetic is correct, making liabilities approximately three times the total assets of the partnership and the individual partners. These figures were confirmed, and all three partners testified that they were approximately in the same condition financially for a year prior to the filing of the petition. [See testimony of Sol Zemansky, Tr. pp. 185, 186; David Zemansky, Tr. pp. 347, 348 and 389, 390; Abe Zemansky, Tr. pp. 387, 388, 389.]

It does not appear to be seriously disputed by the Appellant that a hopeless condition of insolvency existed at the date when the purported security was given February 24, 1941. Kleinman only contends that he had no idea that the Zemanskys were, or might be insolvent.

When we refer to February 24th, 1941, we do not, however, concede that the agreement was executed on that date. On the contrary the evidence shows that it was signed by Sol Zemansky at San Francisco around the 24th or 25th of February. It was not, however, signed by the other partners until the night of the 27th of February, after the Simons attachment had been run and the sheriff was in possession of the bankrupts' places of business.

David Zemansky testified [Tr. p. 349] that it was on the night of the Simons deal at the Provident Loan office, participated in by William Simon, Mike Lyman and a representative from Isaac Pacht's office that the signatures of himself and his brother Abe were affixed to the con-

tract dated February 24, 1941. Abe Zemansky testified [Tr. p. 63] that he believed it was on the 27th of February when they were straightening out the attachment on the place with Simons for the money that they owed him, and that it was signed by them that night. Furthermore, it was Abe Zemansky's recollection that the agreement had not even been signed by Kleinman at that time, although he was there that night. [Tr. p. 364.]

It was conceded by Mr. Wolver, Kleinman's attorney at the trial, that Kleinman was in a highly nervous condition, having, to quote his exact words, "a nervous relapse at that time." [Tr. p. 265.] Simon had assumed a very threatening manner, according to Sol Zemansky, speaking in a loud tone of voice and telling the bankrupts that "they would have to pay off, or else." [Tr. p. 264.] Sol Zemansky told him it could not be done that way. [Tr. p. 264.]

Kleinman testified at page 476 of the Transcript, that he did not know if Zemanskys owed any money on February 24th. This cannot be said to have been the situation on February 27th, 28th, and at subsequent times. There seems to be no question but that the agreement was actually executed on either February 27th or February 28th. David and Abraham Zemansky were under the impression that the conference between the bankrupts and Judge Pacht and Kleinman took place on the evening of the 27th and that the agreement was signed at or after the conference. Mr. Dienstag, however, fixed the conference as having been held on February 28th between 8 o'clock and midnight. [Tr. pp. 526, 527.]

At the time the two Zemanskys and probably Kleinman signed this agreement on the night of the 28th, Klein-

man certainly had ample notice that something was radically wrong financially in the Zemansky institution. Sol Zemansky had frantically telephoned Kleinman at San Francisco a day or so before that, to come to Los Angeles, without apparently informing him what the trouble was. On his arrival at Los Angeles he and his son-in-law, Mr. Dienstag, went directly to the Provident Loan Association and Kleinman said to Sol Zemansky, "What is this matter, you want twenty-five or thirty thousand dollars?" [Tr. p. 524.] Sol told him that Simon had run an attachmnt on their business and they wanted the money to lift the attachment. The fact that an obligation of twenty-five or thirty thousand dollars or more was long enough past due to warrant the holder of it in suing and attaching their places of business should have put Kleinman on his inquiry as to the financial condition of a firm which was then under attachment and which was having to pay the prohibitive rate of 12% interest for money, when if it were regarded as a good credit risk, could have obtained the same funds from a bank at seven or eight per cent or less.

The question of insolvency of the Zemanskys arose at this conference also, when Judge Pacht asked Sol Zemansky whether or not they were insolvent or, as Judge Pacht put it "bankrupt". [Tr. pp. 510, 511.] Judge Pacht put it up to Sol Zemansky, as follows:

> "If you can't pay your debts in full, tell us so and we will know where to go from there. It is not the first time that a creditor has had to write off an obligation in whole or in part."

This discussion as to solvency of the partnership was brushed aside with the offhand statement that they had

more assets than liabilities but were hard pressed for cash. Kleinman was present at that conversation. [Tr. pp. 511, 512.] Arrangements were then made to use some of the pledges which had been set aside for Kleinman to secure Simons, at least in part. [Tr. p. 531.]

Nowhere in the record is there any evidence that this Appellant or his son-in-law asked the Zemanskys or any of them, *how much* they owed. Later on in April, part of Kleinman's pledges were used to secure one Bob Gans on an indebtedness. [Tr. pp. 459 to 462.] Kleinman testified that he was surprised when he learned that they owed money to Bob Gans, but despite his surprise there appears no evidence that he inquired how much was owing, but very pliably consented to the diversion of $12,000 worth of his pledges to go as security to Gans. [See Tr. p. 460 and Kleinman's Exhibit No. 8, Tr. p. 463 *et seq.*]

Considering the magnitude of Kleinman's claim, the fact that he had been in the employ of the Zemanskys for several years, had an office right in their place of business [Tr. p. 237], was thoroughly familiar with the value of pawned gems, and had acted for years as a sales agent for the bankrupts on foreclosed pawns, it would be logical to assume that when the sheriff descended on Zemanskys' places of business with a writ of attachment, and with Kleinman, a shrewd moneylender, about to take security for well in excess of $100,000.00 worth of obligations due him, if he were acting in good faith, in so far

as his ignorance of the bankrupts' insolvency was concerned, he would have at least asked the Zemanskys for a full statement of *how much* they owed to people other than himself, and with that knowledge in his possession he could have made at least a rough appraisal of the assets available to meet those liabilities and realized that he had no right to take security, or at least no reason to depend upon its validity because of the possibility of bankruptcy ensuing within four months. It should have been a very simple matter, before the execution of the agreement, dated February 24th but actually not executed until February 28th, to have sat down with the Zemansky brothers, or any of them, and totaled up their accounts payable and notes payable from their books, and if he had done so Kleinman would have found that the Zemanskys actually owed $1,341,698.66, or thereabouts. He would have learned that they did not know how much they owed in social security and other taxes, which would enhance their liabilities. Instead of that, he appears to have studiously avoided asking any direct questions as to their liabilities, and the lower courts were right in assuming from the facts surrounding the transaction that he knew, or had reasonable cause to believe that the bankrupts were insolvent on or about February 24, 1939, when the arrangement to take security got underway.

Another circumstance which may be taken into consideration was the speed with which this transaction was consummated. Kleinman had worked for the Zemanskys for many years. According to him his health suddenly

gave out and practically over night he decided he was going to quit and he wanted security for his money. He went to San Francisco and conferred with his attorney son-in-law. They came to Los Angeles almost immediately and negotiations were opened with Sol Zemansky to secure Kleinman. Mr. Dienstag went back to San Francisco and then came back to Los Angeles and prepared the agreement dated February 24th. When the mechanical work of preparing the agreement was completed Messrs. Kleinman and Dienstag discovered that Sol Zemansky had been called to San Francisco on business. Mr. Dienstag promptly followed Sol Zemansky to San Francisco and contacted him through his hotel. He obtained Sol's signature on the agreement there. Kleinman then hurried to San Francisco and Sol Zemansky came back to Los Angeles. Shortly after Kleinman arrived in San Francisco Zemansky called him from Los Angeles on long distance telephone and apparently informed him they were in trouble of some kind. [Tr. pp. 411, 412, 413.] Kleinman rushed back to Los Angeles by plane, accompanied by Mr. Dienstag. [Tr. p. 524.] According to Kleinman, Mr. Dienstag was either afraid to ride on a plane or did not like it. [Tr. p. 452.] Apparently the exigencies of the situation required that he overcome his aversion to this more efficient and speedy means of transportation, and he came down with Appellant and stayed with him throughout the negotiations on the night of February 28th, and then took another plane right back to San Francisco. [Tr. p. 536.]

This shuttling back and forth repeatedly between San Francisco and Los Angeles, a distance of approximately five hundred miles over a period of four or five days clearly indicates the pressure under which Kleinman and his attorney were laboring to get this security transaction "buttoned up" at the earliest possible moment before something happened.

Kleinman's intimate contact with the Zemanskys could very easily lead the trier of fact to conclude that he knew something about the menacing attitude that was being assumed by Simon, which culminated in the levy of the attachment, even before the agreement bearing date of February 24, 1939, had been fully executed. The fact that Kleinman was on the verge of a nervous collapse at the conference held on the night of February 28th at which Simon told Zemansky in a loud tone of voice that "they had better pay up, or else," was merely the culmination of a dammed up emotional strain existing over a period of days which manifested itself in the hectic movements back and forth of Appellant and his son-in-law Mr. Dienstag between Los Angeles and San Francisco.

We respectfully submit that there is more than sufficient evidence in the record, of the insolvency of the Zemanskys, and of reasonable cause to believe that that condition existed, on the part of Kleinman, and that the Referee who saw the witnesses and heard their testimony from their own lips was the best judge of their credibility, their sincerity and of the interpretation and construction

to be placed on the circumstances surrounding the transaction. On conflicting evidence he concluded, despite Kleinman's pious protests of surprise and ignorance, that the circumstances surrounding the transaction were such as to cause a reasonably prudent man to make an investigation into facts which were at his finger tips, which investigation would have easily demonstrated the hopelessly insolvent condition of the Zemanskys. The subterfuge resorted to in the subsequent contracts in an endeavor to make it appear that Kleinman continued to make new loans to the bankrupts by manufacturing cancelled checks drawn in favor of the bankrupts on Kleinman's daughter's bank account, cashing the same and immediately returning the money to Kleinman, certainly went a long way toward impugning the good faith of Appellant. [Tr. pp. 365 to 369, and Tr. pp. 434 to 440.] In fact the transaction in connection with these manufactured checks was so unusual that it even attracted the attention of the impersonal bank teller at the Union Bank, at whose window these checks were repeatedly cashed, causing him to inquire of Abraham Zemansky the reason for it. Kleinman, on being informed by Abe Zemansky of the teller's inquiry, told him to tell the teller that it was Kleinman's own money in the bank and it was no business of the teller's to inquire of him the system of putting the money back again. [Tr. p. 368.] After the teller's suspicions had been aroused Kleinman then changed the system to making out two checks instead of one and presenting them at different times to get the cash to circulate in the merry-go-round

operated between the Zemanskys and Kleinman. [Tr. p. 368.]

We submit that people acting in good faith do not choose round-about and devious methods to accomplish legitimate business transactions, where such devious methods can be avoided. To say the least it is inefficient, and a business man shrewd enough to exact ten and twelve per cent on his money over a period of years certainly is not going to throw money away on airplane trips back and forth between Los Angeles and San Francisco and go through a complicated system of cashing checks at a bank, in company with another party and circulating the money back to its source in cash thereafter, as was done here. Both the referee and the district judge saw through this subterfuge. In fact, District Judge Hollzer in his opinion [Tr. p. 80] states that the explanation given by Appellant of the transaction "challenges one's credulity." Possibly the referee and district judge were also impressed with the apparent speedy recovery of Kleinman's health and from his nervous condition after he had obtained his security.

Bearing in mind the fact that he claimed his reason for wanting security was that he was resigning because of his health, it is significant to note from an examination of the record throughout that he still remained with the Zemanskys after the contract of February 24th had been executed, had numerous dealings with them at the Union Bank, and apparently made himself such a nuisance around the vault that, according to his own testimony, the loan clerk asked him to stay out of the vault when people came in to redeem their pledges and let the loan clerk take them out. [See Tr. pp. 456 to 461; 471, 472; 485 to 488 and 498, 499.]

The Law on the Question of Preference.

That transactions of the nature of those had between the bankrupts and Kleinman clearly constitute a preference is well-settled by the recent case of *In the Matter of Quaker City Sheet Metal Co., Bankrupt,* 129 Fed. (2d) 894, 50 Am. B. R. (N. S.) 345, a case similar to the case at bar, where accounts receivable were pledged without notice to the debtor of the assignment of his accounts. The Circuit Court of Appeals for the Third Circuit held in that case that the assignment was not perfected as against subsequent *bona fide* assignees or as creditors, and that under the provisions of §60 of the Bankruptcy Act it would be deemed to have been made immediately before bankruptcy. In the case at bar no notice was given to any of the borrowers that their pledges or their pawn tickets had been given to Appellant Kleinman as security. [Tr. p. 190.]

In *Banco Commercial De Puerto Rico v. Boscana,* 100 Fed. (2d) 449, 38 Am. B. R. (N. S.) 632, the Circuit Court of Appeals for the First Circuit said:

> "A bankrupt's purported delivery of merchandise to a creditor by a notarial deed intended to identify the merchandise covered by a previous defective contract of sale and resale, such contract having been given as a pledge to secure payment of an indebtedness of the bankrupt, constitutes a voidable preference under §60 where such delivery occurs within four months of the filing of the petition in bankruptcy, although the original contract was prior to the four months period."

In the case at bar it is undisputed that both the pledges and the pawn tickets remained in the possession of the

bankrupt throughout and were never under the dominion of Appellant.

In *Wolfe v. Bank of Anderson,* 238 Fed. 343, 38 Am. B. R. 387, the Circuit Court of Appeals for the Fourth Circuit reversed an order of the District Court sustaining a transaction similar to the one here, where pledged accounts were permitted to be collected by the bankrupt and new accounts substituted over a period of years, ultimately extending down to within four months preceding the filing of the petition. The Circuit Court of Appeals held that such a transaction constituted a voidable preference under §60 of the Bankruptcy Act.

For other cases along the same line see:

In re Busby, 124 Fed. 669, 10 Am. B. R. 650;

First National Bank v. Ragsdale, 294 Fed. 382, 2 Am. B. R. (N. S.) 255 (C. C. A. 5th Cir.).

a case where the assignment was made for a past due indebtedness after an attachment had been levied on the bankrupt's property; the assignment being executed pursuant to an oral agreement made more than four months prior to the filing of the petition, but actually executed within that period.

Gould v. Nathans, 1 Fed. (2d) 458, 2 Am. B. R. (N. S.) 790 (D. C. Mass.);

Matter of Robert Jenkins Corporation, Bankrupt, 1 Fed. (2d) 979, 7 Am. B. R. (N. S.) 504 (D. C. Mass.);

Lone Star Cement Corp. v. John B. Swartwout, 93 Fed. (2d) 767, 35 Am. B. R. (N. S.) 216 (C. C. A. 4th Cir.).

The Case at Bar Is so Nearly Parallel to the Case of Benedict v. Ratner, 268 U. S. 353, 45 Supreme Court 566, 6 Am. B. R. (N. S.) 9, That the Order Appealed From Should Be Affirmed on the Authority of That Case Alone.

The case of *Benedict v. Ratner,* 268 U. S. 353, involved a situation very similar to the case at bar. The case arose in the Southern District of New York. The law of New York with regard to assignments of choses in action is much more liberal than is the law of California. In New York it is not required, in order to make an assignment of choses in action valid as against subsequent purchasers in good faith, that any notice be given to the debtor. The contrary is the rule in California. The bankrupt in that case assigned as collateral for certain loans, all of its accounts, present and future. No notice was given to the debtors, as it was not required under the New York rule. The bankrupt was permitted to retain the accounts, to make the collections thereon, and to use the money derived therefrom in connection with its business the same as Kleinman permitted the bankrupts here to do. The assignee of the accounts was given the right at any time to demand a full disclosure of the business and financial conditions, to require that all amounts collected be applied on the payment of his loans, and to enforce the assignment, though no loan matured. Unless such demand was made the bankrupt was not required to apply any of the collections to the repayment of Ratner's loan. The existence of the assignment was to be kept secret and the business was to be continued as theretofore.

The trustee attacked the transaction in the United States District Court for the Southern District of New York

unsuccessfully. The Circuit Court of Appeals for the Second Circuit affirmed the order of the District Court. (*Benedict v. Ratner,* 282 Fed. 12.) The Supreme Court of the United States, in reversing the judgment of the Circuit Court of Appeals, after stating that "the rights of the parties depended primarily upon the law of New York" (*Hiscock v. Varick Bank,* 206 U. S. 28) said:

> "The results which flow from reserving dominion inconsistent with the effective disposition of title must be the same whatever the nature of the property transferred. The doctrine which imputes fraud where full dominion is reserved, must apply in assignment of accounts, although the doctrine of ostensible ownership does not. There must also be the same distinction as to degrees of dominion. Thus, although an agreement that the assignor of accounts shall collect them and pay the proceeds to the assignee will not invalidate the assignment which it accompanies, the assignment must be deemed fraudulent in law if it is agreed that the assignor may use the proceeds as he sees fit.
>
> "In the case at bar the arrangement for the unfettered use by the company of the proceeds of the accounts precluded the effective creation of a lien and rendered the original assignment fraudulent in law. Consequently the payments to Ratner and the delivery of the September list of accounts were inoperative to perfect a lien in him, and were unlawful preferences. On this ground, and also because the payment was fraudulent under the law of the state, the trustee was entitled to recover the amount."

The case of *Young v. Upson,* 115 Fed. 192, cited by Appellant at page 19 of his brief, is easily distinguishable on the facts. In the first place, the opinion affirmatively

states that: "The proceeds of accounts collected were immediately paid to the lender." That is not the case here. The opinion also states that it was not essential to the validity of the transfer that notice should have been given to the debtors whose claims were assigned. It will be noted, however, that that case was a Second Circuit case where the New York rule was applied. The rule in California is otherwise, and in the case at bar prevails.

Hiscock v. Varick Bank, 206 U. S. 28.

The matter of *Federal Piano Corporation,* 37 Fed. (2d) 556, cited at page 23 of Appellant's brief is likewise distinguishable on the facts. The facts indicate that in that case every sixty days, the bankrupt was required to apply all collections made on the accounts to the curtailment of the note, and that every dollar collected was ear-marked for the specific purpose mentioned.

In the case at bar, where were any of the proceeds of collection on the pawns or pawn tickets applied toward the reduction of Kleinman's indebtedness? Invariably whenever collections were made, if the money was turned over to Kleinman at all it was immediately handed back either through the medium of a check jointly cashed by Appellant and one of the bankrupt partners, or if made in currency, was dropped into a drawer in Kleinman's desk and given back to the bankrupt. [Tr. pp. 485 to 487.]

In the *Federal Piano Corporation* case, *supra,* the court said:

> "The test in all such cases seems to be whether the assignor retains unfettered dominion over nominally assigned accounts and their proceeds. If so, the assignment is fraudulent. Otherwise it is not."

The two lower courts unqualifiedly found as a fact that Kleinman had not retained unfettered dominion over the nominally assigned pawn tickets and united in the conclusion that the assignment was not made in good faith and for a present consideration.

See *Chapman v. Emerson,* 8 Fed. (2d) 353, cited by Appellant at pages 20 and 21 of his brief.

In *Pender v. Chatham Phenix National Bank & Trust Co.,* 58 Fed. (2d) 968, 21 Am. B. R. (N. S.) 315, the Circuit Court of Appeals for the Second Circuit reversed a decree for the defendant, in the following language:

> "The sole dispute is whether they (the facts) gave the bank reasonable cause to believe that a preference would be effected by the payment. The District Judge expressed the opinion that the case was 'pretty close,' but concluded that the bank did not have reasonable cause to believe that its debtor was insolvent in the bankruptcy sense. With this conclusion we are unable to agree. The bank knew that for six months Sugarman had been increasingly slow in paying his bills, that his commercial credit rating had been withdrawn by the National Credit Office, that his bank balances had steadily dwindled, and that he would be without banking credit when forced to close his account with it. It had expressed dissatisfaction with Sugarman's explanation of his former partner's overdrawing account, and it resorted to the unusual procedure of requiring payment of its debtor's notes before they were due and out of discounted bills receivable. It realized that its loan was 'very shaky,' and was advised by Mr. Debevoise to get assigned accounts as security until it could work out of the risk. These circumstances raised more than suspicion of danger;

> we think they were enough to put the creditor upon inquiry touching the debtor's insolvency and that adequate inquiry would have disclosed his insolvency. *In preference cases, notice of facts which would incite a man of ordinary prudence to an inquiry under similar circumstances is notice of all the facts which a reasonably diligent inquiry would have disclosed.* (Italics ours.) See Wright v. Skinner Mfg. Co., 162 Fed. 315, 20 Am. B. R. 527 (C. C. A. (2nd Cir.); Boston National Bank v. Early, 17 Fed. (2d) 691, 9 Am. B. R. (N. S.) 460 (C. C. A. 4th Cir.); Ridge Avenue Bank v. Sundheim, 145 Fed. 798, 16 Am. B. R. 863 (C. C. A. 3rd Cir.) Shale v. Farmers' Bank (Kan. Sup. Ct.), 82 Kansas 649, 109 Pac. 408."

In the case at bar the repeated shortage of cash, the rejection of loans for that reason, the necessity on the part of the bankrupts of paying 12% for private money where if they had bank credit they could have obtained the money at a much lesser rate of interest, the belligerent attitude of at least one large creditor, Mr. Simon, the attachment levied on their places of business, the speed and haste with which the transaction was consummated, we submit brings the case at bar well within the limits of the holding in the previously cited cases.

That Kleinman was aware of a shortage of money to make loans and the rejection thereof prior to taking his security is evidenced by the testimony of the loan clerk, Leo Kravitz. [See Tr. pp. 281, *et seq.*]

> "Q. Did you ever turn down loans because there was not sufficient money in the cash drawer? A. Yes, sir.

Q. Was that before Mr. Kleinman got the security? A. Yes, sir.

Q. And were there very many occasions like that? A. Off and on.

Q. Did these occasions arise after you had called Dave Zemansky for money? A. Yes, sir.

Q. And did those occasions arise after you asked Mr. Kleinman for money? A. Yes, sir. * * *

Q. Did you and Mr. Kleinman ever sit around and talk on any of those occasions? A. We use to talk about diamonds and the loans.

Q. Did you ever talk about the condition of the business at the Provident? A. Yes, we talked about it.

Q. What was your conversation? A. The condition of the business and how you are going to make loans.

Q. Who said that? A. There is no money in the till, Mr. Kleinman used to say that.

Q. Give us the rest of the conversation? A. I said, 'Well, Sam, if we can't make any loans, I will get some money off of Dave or get a little money off of you if a loan comes in.' In the meantime, a redemption would come in and I would loan that money, and I wouldn't have to ask him. This is just casual talk we used to have all day long.

Q. Did those conversations take place prior to the time that security was set aside for Mr. Kleinman? A. Before and after."

The Attempted Repledging of the Pawns in the Possession of the Zemanskys to Kleinman Without Immediate Delivery Followed by an Actual and Continued Change of Possession Was Fraudulent and Void Under the Provisions of §3440 of the Civil Code of California and §70-e of the Bankruptcy Act (11 U.S.C.A., §110-e).

At the opening of this brief we set forth the provisions of §3440 of the Civil Code requiring immediate delivery followed by actual and continued change of possession of all personal property other than things in action, and every lien thereon, other than a mortgage, when allowed by law, as being conclusively presumed to be fraudulent and void as against creditors of the transferor.

We also set out the statutes of this State regarding the necessity for delivery of personal property sought to be pledged.

The appellant has sought to circumvent these plain statutory provisions by contending that it was not the intent of the parties to pledge the pawns as security for Mr. Kleinman's claim, but that they only intended to pledge the pawn tickets, the evidences of the debt. This, appellant contends, does not bring the transaction within the provisions of §3440 of the Civil Code nor within the various statutory provisions relating to pledges, inasmuch as "things in action" are expressly excepted from the provisions of §3440.

The referee and the District Court were both satisfied, from the evidence in the case, that it was not the mere naked pawn tickets that Mr. Kleinman relied upon as security, but the tangible pawns by which the pawn tickets themselves were secured.

In his excellent opinion District Judge Hollzer [Tr. pp. 73, 74] analyzed this contention, in the following language:

> "By admitting that under California law a pawnbroker is prohibited from pledging 'tangible pawns' prior to the expiration of the time within which the same may be redeemed, and by contending that 'the true object of Kleinman's pledges were the customers' pawn tickets,' does claimant thereby concede that he asserts no interest in said 'tangible pawns,' that he has no right to control the disposition of the same, and that he is not entitled to have the proceeds derived from the sale thereof applied toward the payment of said notes?
>
> In neither of the briefs filed on behalf of claimant have we found an unequivocal, affirmative answer to this question. The oral argument likewise gave no such answer. * * *
>
> Examined in the light of the restrictions sought to be imposed by the terms and conditions set forth in the provision last quoted, the acts and conduct of the parties, not merely those referred to in the above mentioned fourteen separate and distinct steps, but also those disclosed by the balance of the evidence, clearly demonstrate that the parties to said contract considered that the 'customers' pawn tickets' as distinguished from the 'tangible pawns' that is to say, that these so-called choses in action, if separated from and deprived of the security represented by the 'tangible pawns,' had virtually no value. Accordingly, as shown by the evidence, claimant undertook through various devices to effectuate not merely the segregation and identification of some 1200 pawn tickets, but also the segregation and identification of the corresponding 'tangible pawns,' which alone gave

these choses in action whatever value they possessed as security for the payment of the notes held by him. All of this was designed to deprive the bankrupts of all real control over such 'tangible pawns,' and to transfer the same to claimant, and thereby bring about the surrender, and in effect, the pledge of such 'tangible pawns' to the latter.

Obviously claimant never has been willing, and in this proceeding has not offered, to allow the proceeds from the sales of these 'tangible pawns' to be disposed of on the basis that he has no lien thereon, and has never acquired any primary claim thereto.

Thus it becomes clear that through the instruments executed by claimant and the bankrupts, and by the acts and conduct of the parties, the former undertook to secure a pledge lien upon the 'tangible pawns,' and thereby accomplish indirectly that which the law forbade the bankrupts as pawnbrokers from doing directly."

That it was the intent of the parties to convey the benefit of the tangible pawns as security to Kleinman is clearly evidenced by the Seventh and Ninth paragraphs of the Agreement bearing date of February 24, 1939. [Trustee's Exhibit No. 4.] These paragraphs are found at pages 115 and 116 of the Transcript of Record. Under the Seventh clause of the Agreement the Zemanskys were required to retain in their possession every article pledged and pawned to them in respect to and by virtue of the foregoing pawn tickets, and in the event of default on the part of the customers, were required to retain the articles so pledged and pawned for the benefit of and to the order of Mr. Kleinman.

In paragraph Nine of the Agreement it was made very clear that Kleinman was not to be deemed to be either a partner or a joint adventurer with the Zemanskys, but was to be merely a lender, creditor, or pledgor of the parties.

It is inconsistent, with these provisions, for appellant now to claim that the pawn tickets were separable from the tangible pawns and that it was merely the pawn ticket, or right to receive money therefrom, that he was relying upon for security. If he were merely relying upon the pawn ticket, why the provision in Trustee's Exhibit No. 4 for the retention by the Zemanskys of the tangible pawns either before or after foreclosure?

It is also to be noted that Trustee's Exhibit No. 4 gives Kleinman no dominion over either the pawns or the collections. Paragraph Four of Trustee's Exhibit No. 4 [Tr. p. 114] expressly provides that the Zemanskys were to collect any sums of money which might be due, owing or unpaid upon and in respect to each of the pawn tickets and pledge agreements, and that they were to hold such proceeds in trust for the purpose of applying the money so collected to the payment of the twenty promissory notes. In other words, dominion over the pawn tickets, dominion over the pawns, and dominion over the collections was expressly reserved in the debtor. That the money received from the redemption of Kleinman's pledges was commingled with the funds of the bankrupt and treated the same as the bankrupt's money is evidenced by the testimony of Leo Kravitz, the loan clerk at page 290 of the Transcript. We quote:

> "Q. What did you do, Mr. Kravitz, when a customer would come in and want to make a redemption

of a pledge and that was one of the pledges that had been set aside for Mr. Kleinman? A. I used to go in the vault and get it and give it to the customer.

Q. What did you do with the money that the customer gave you? A. I used to put it in the cash box.

Q. What did you use the money for after you put it in the cash box? A. Loaned it out. * * *

Q. When you put the money in the cash drawer, on one of those redemptions, did you put it in any other section of the cash drawer than the place where you would put any of the money? A. In the same drawer. * * *

Q. I will withdraw the question, Mr. Kravitz, did Mr. Kleinman ever make a redemption of a pledge that has been set aside to him for security? A. Yes, sir.

Q. What did he do with the money when he received it from a customer? A. Put it in the drawer.

Q. In the same manner that you had done? A. Yes, sir.

Q. And was that money used over again for the purpose of making new loans to customers? A. Yes, sir."

It requires no extensive citation of authority to establish the fact that throughout the entire period of statehood in California transfers of personal property and liens thereon, without immediate delivery followed by actual and continued change of possession, with the exception of promptly recorded chattel mortgages, have been held to be null and void as against creditors. The policy of the law in this State has been consistently hostile to secret liens.

See:

Bank of America National Trust and Savings Association v. Sampsell, 114 Fed. (2d) 211, 44 Am. B. R. (N. S.) 88;

Ruggles v. Cannedy, 127 Cal. 290;

Noyes v. Bank of Italy, 206 Cal. 266;

Washington Lumber & Mill Co. v. McGuire, 213 Cal. 13.

But beyond that the policy of the law in California is against the assignments of even choses in action without notice, independent of the statute. It has been consistently held by the Supreme Court of California that the pledging of choses in action is of no effect as against a subsequent *bona fide* purchaser, without notice, unless notice is given to the debtors of the pledging of their obligation to the assignee thereof. This admittedly was not done in the case at bar. Sol Zemansky testified at page 190 that the bankrupt never sent any notice to any of its customers that their pledges had been given to Mr. Kleinman as security, nor were any notices of any kind sent to those customers regarding that subject matter, and that collection on those pledges was made by any of the employees of the place, and that if any of the customers failed to redeem the pledge within the time allowed, notices were sent to them by the bankrupt regarding the interest, at three months, nine months and twelve months, and unless the pledge was then redeemed, they would dispose of the pawn as an expired pledge. [See Tr. p. 190.] This testimony of Sol Zemansky stands uncontradicted.

Section 60-a of the Bankruptcy Act has been strengthened by the amendment of 1938, placing the trustee, where

a preference is concerned, in the same status as that occupied by a *bona fide purchaser* from the debtor. We quote from the language of §60-a:

> "For the purposes of subdivisions a and b of this section, a transfer shall be deemed to have been made at the time when it became so far perfected *that no bona fide purchaser from the debtor* and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and, if such transfer is not so perfected prior to the filing of the petition in bankruptcy or of the original petition under Chapter X, XI, XII or XIII of this Act, it shall be deemed to have been made immediately before bankruptcy." (Italics ours.)

See also Section 67D, Subd. 5, as amended in 1938.

For a recent construction of this amendment we again refer the court to the decision of the United States Circuit Court of Appeals for the Third Circuit in the *Matter of Quaker City Sheet Metal Co., Bankrupt,* 129 Fed. (2d) 894, 50 Am. B. R. (N. S.) 345. In that case, as we shall presently point out, the Circuit Court of Appeals had before it a case involving the same rule of State law with regard to assignment of choses in action as we have here. What is the rule in California with regard to the validity of assignment of accounts receivable?

In California, in order to make an assignment of a chose in action or an account valid as against subsequent purchasers or assignees in good faith, notice must be given to the debtors by whom the account or chose in action is owed to the original assignor, and if such notice is not given, the assignment is void as against subsequent purchasers or assignees.

In *Graham Paper Co. v. Pembroke,* 124 Cal. 117, the Supreme Court of California was apparently called upon for the first time to determine whether or not in California the English rule with regard to the validity of assignment of accounts or the New York rule should be followed. After discussing the fact that the English rule was well-established, that as between successive assignees of a chose in action, the one that first gives notice to the debtor would prevail, provided at the time of taking it he had no notice of a prior assignment, and after calling attention to the fact that the English rule had been followed by the Federal Courts in this country, the Supreme Court of California said:

> "Appellant cites a large number of New York cases in support of its contention, and it must be conceded that they sustain the general proposition that the prior assignee has the better right, though he has not notified the debtor. We think, however, that the doctrine announced by the English courts, and followed by our Federal Courts and the State Courts above mentioned, is based upon the better reason and sustained by the weight of authority. Notice to the debtor not only protects the assignee against payment to the assignor, but against payment to the subsequent assignee, since the debtor, with notice of the prior assignment, would be no more protected by a payment to a subsequent assignee than he would by paying to the assignor; and, besides, an intending purchaser of the accounts from the assignor would have it in his power to ascertain from the debtors, by inquiry, whether any prior assignment existed, and would thus be furnished with the only reasonable protection possible against fraud on the part of the assignor."

In *Smitton v. McCullough,* 182 Cal. 530, at 535, the Supreme Court of California said:

> "Where, however, a person entitled thereto assigns a fund in the hands of a third person, the rule is established in this State that notice to the holder of the fund is necessary to render the assignment valid and effectual as against subsequent assignees without notice and for a valuable consideration. (Graham Paper Co. v. Pembroke, 124 Cal. 117; Widenmann v. Weniger, 164 Cal. 667; 2 Pomeroy's Equity Jurisprudence, 4th Ed. §695.) Such notice may be either written or oral. (2 Pomeroy's Equity Jurisprudence, 4th Ed. §696.)"

In the late case of *City of Los Angeles v. Knapp,* 7 Cal (2d) 168 at 171, the Supreme Court of California, after citing the foregoing cases, again reiterated the principal, in the following language:

> "As between two *bona fide* assignees for value, the one who first gives notice to the debtor acquires priority."

See, also:

The Elm Bank, 72 Fed. 610.

Section 67-d, Subdv. (5) of the National Bankruptcy Act (11 U.S.C.A., §107-d(5)) as amended, effective September 22, 1938, contains the identical provision, as does §60-a, with regard to the time when the transfer shall be deemed to have been made; namely, at the time when it became so far perfected that no *bona fide purchaser* from the debtor, and no creditor could thereafter have acquired any rights in the property so transferred, superior to the rights of the transferee therein, and if such transfer is

not so perfected prior to the filing of the petition, it is deemed to have been made immediately before bankruptcy.

Now let us examine, in the light of the preceding cases, the situation as it existed in the Provident Loan Association. In the bankrupt's vaults were well in excess of $100,000.00 worth of valuable pledges deposited by customers as security for loans obtained by them from the Zemansky Brothers. The customer had one pawn ticket and the Zemanskys had another. On the outside of the pledge envelope was the letter "K," and a number on the inside with the pledge. The pawn tickets retained by the Zemanskys had been endorsed with identifying indicia understandable only by the Zemanskys and Kleinman. The pawn tickets remained in the Provident Loan place of business after the arrangement was made between Kleinman and the Zemanskys, as well as before, with the Zemanskys empowered with a secret agency by Kleinman to collect on these repledged pawns. Leaving the prohibition against relinquishing possession on the part of a pawnbroker out of the picture entirely, let us assume that a legitimate, *bona fide* licensed pawnbroker had approached the Zemanskys and opened negotiations to purchase their pawnbroking business; let us assume that the Zemanskys gave him no information whatsoever that over $100,000 worth of pawns and pawn tickets had theretofore been assigned to Mr. Kleinman; let us assume that the pawnbroker bought the Provident Loan Association business in its entirety and took possession of the pawn shop of the Provident Loan Association, *could Kleinman assert a claim to either the tangible pawns or the pawn tickets accompanying them, as against the claim of this bona fide purchaser of Zemansky's business?* (Italics ours.) We sub-

mit that under the laws of California and under the provisions of both §60 and §67 of the National Bankruptcy Act the answer would have to be an unqualified *"NO."* That being the case the transfer as defined under §1, Subdv. (30) of the National Bankruptcy Act (11 U. S. C. A., §1 (30)) as amended September 22, 1938, was absolutely null and void as against the trustee, and was also clearly preferential. We can even safely assume, although we do not concede, that had the bankrupts been solvent on February 24, 27 or 28 of 1939 the transfer would still be both fraudulent and preferential, as under both §60 and §67 it was deemed to have been made immediately before bankruptcy, at which time there is not the slightest dispute of the bankrupt's insolvent condition and of Mr. Kleinman's reasonable cause to believe that such condition existed, he having remained around Zemansky's place of business to see the attachment lifted only by hypothecating his own pawns to do so, to the extent of fifty per cent of the Simon loan [Tr. p. 529], and having to do the same, much to his surprise, as appears at Tr. p. 459, with another indebtedness owing Bob Gans, about which he had previously claimed to have known nothing.

As was said by Mr. Justice Brandeis in *Dean v. Davis,* 242 U. S. 438, 38 Am. B. R. 664:

> "A transaction may be invalid both as a preference and as a fraudulent transfer. It may be invalid only as a preference or only as a fraudulent transfer."

In that case Mr. Justice Brandeis held that a mortgage given for a contemporaneous loan with the intent on the part of the bankrupt to use it to effect a preference to a bank which held forged notes which he had discounted,

was invalid under §67 of the Bankruptcy Act of 1898 as it existed at that time. Section 67, as it now reads since the 1938 amendment, in so far as material here, is as follows:

> "Section 67-d (2-d). Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition in bankruptcy or of an original petition under Chapters X, XI XII or XIII of this Act by or against him is fraudulent, * * * (d) as to then existing and future creditors, if made or incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either existing or future creditors."

Subdivision (5) of this sub-section, as pointed out before, fixed the date of the transfer as immediately before the filing of the petition, unless the transfer so perfected was to be unassailable by a *bona fide* purchaser from the debtor of the property.

Subdivision (7) of this sub-section provides:

> "Nothing contained in this subdivision d shall be construed to validate a transfer which is voidable under §60 of this Act."

In the case of *Dean v. Davis, supra,* Justice Brandeis was careful to point out:

> "But under §67-e the basis of invalidity is much broader. It covers every transfer made by the bankrupt 'within four months prior to the filing of the petition, with the intent and purpose on his part to hinder, delay, or defraud his creditors, or any of 'them' 'except as to purchasers in good faith and for a present fair consideration.' As provided in §67-d. only 'liens given or accepted in good faith and not in contemplation of or in fraud upon this Act' are un-

assailable. A transfer, the intent (or obviously necessary effect) of which is to deprive creditors of the benefits sought to be secured by the Bankruptcy Act, 'hinders, delays or defrauds creditors' within the meaning of §67-e."

Conclusion.

This case comes before this court after having been thoroughly and painstakingly tried before an able referee who saw the witnesses as they testified, had an opportunity to judge their credibility and their good faith by personal contact with them in the witness box. He unhesitatingly found against them on disputed questions of fact. The findings of fact leave nothing whatsoever to conjecture or speculation as to whether or not this was a *bona fide* transaction or a fraud and a preference. A review was then taken to the District Court. It was argued before Judge Hollzer, commencing Monday, July 21, 1941, as appears at page 557 of the Transcript of Record from the Reporter's Transcript of the proceedings on the argument. That the learned district judge gave this record a most complete, thoroughgoing and painstakinging review is evidenced by the fact that the memorandum of conclusions of Judge Hollzer [Tr. p. 55] bears date of February 6, 1942, over six months after the argument.

This is not a case wherein the district judge perfunctorily reviewed the evidence and the law and affirmed the findings of the referee offhand. The memorandum of conclusions of Judge Hollzer, covering 25 pages of the printed record [Tr. pp. 55 to 80] shows a keen grasp, on the part of the reviewing judge, of the facts and a keen penetration into the minds and motives of the parties to this interesting transaction.

We submit there was no error or suggestion of error on these issues in the findings arrived at by the referee and affirmed by the district judge. We submit that this court should not, and we assume will not interfere, in the absence of clear error.

As was said by this Court in *Swift v. Higgins,* 72 Fed. (2d) 791, in an opinion written by Judge Wilbur:

> "The referee found that the mortgagor was insolvent at the time of giving the new mortgage, and that the mortgagee had sufficient information to put him on inquiry, which, since it would have resulted in his full appreciation of the situation had it been pursued, is sufficient to charge him with knowledge. The evidence in the record on this subject is somewhat meager owing to the fact that the question of the insolvency of the bankrupt on March 1, 1930, was not seriously questioned by the parties at the hearing. * * * The findings of fact were concurred in by the District Court, and we cannot disturb them, there being substantial evidence to support them. Monson v. Hibler (C. C. A. 9th Cir.), 24 F. (2d) 909; Neece v. Durst, 61 F. (2d) 591; Woods v. Naimy, 69 F. (2d) 892)."

In the case at bar appellant seeks to overturn the concurrent findings of the two lower courts. At page 20 of their brief they cite the case of *Chapman v. Emerson,* 8 Fed. (2d) 353. We quote from the authority cited by appellant:

> "The referee and the learned district judge were right in critically scrutinizing their transactions. In the result, however, *they united in the conclusion that the assignment was made in good faith for present consideration,* and that, although the appellees had not

> always insisted on the full measure of their rights, they had never intended to surrender, and had not in fact surrendered, to the bankrupt anything approaching 'unfettered dominion' over the accounts or their proceeds."

In the case at bar the referee and the learned district judge, after critically scrutinizing the transaction complained of, "united in the conclusion that the assignment was *not* made in good faith," and with that conclusion we submit that this court should not interfere. (Italics ours.)

The contention urged by appellant that the tangible pawns were separable from the tickets is a frivolous effort on the part of appellant to bolster up an untenable situation. The nature of the business of a pawnbroker is such that the tickets are not and could not be separable from the tangible pawns. Pawnbrokers do not lend money on mere pieces of paper. They lend it on pledges of tangible personal property delivered into their possession under a pledgor's lien as security for repayment of the debt. The pawn ticket is merely the identification of the tangible pawn and evidence of the amount of the debt which must be repaid to redeem it.

To reverse the judgment of the lower court in this matter would be to work an injustice on other creditors of the bankrupt well in excess of one million and a quarter dollars, who have likewise suffered disaster as a result of extending credit to the bankrupts. They, unlike Kleinman, were not "on the inside" and had no means of knowing the true situation existing in Zemansky's business. They will be obliged to take their pro rata dividends under the provisions of §65-a of the Bankruptcy Act. Mr. Kleinman, after exacting 12% interest for his money, now

seeks to place himself in a preferred position with a secured claim with a rate of interest of 10% per annum until paid, by virtue of his alleged security.

To reverse this judgment will place a premium on sharp business practices designed to circumvent the plain provisions of the law, in favor of one who has the inside track in a failing business institution.

On the other hand, to affirm the judgment of the court will do Mr. Kleinman no wrong, either legally or morally. His claim has been allowed as a general unsecured claim against the bankrupt estate and he will share in *pari passu* with the rest of the creditors of the bankrupt, receiving a dividend of an equal per centum, as contemplated by §65-a of the Bankruptcy Act. He is not entitled to receive any more. (See Bankruptcy Act §65-e, 11 U. S. C. A., Sec. 105E.)

Imperial Paper & Color Corporation v. Sampsell, 313 U. S. 215;

Buffum v. Barceloux Co., 289 U. S. 227.

We respectfully submit that the judgment of the District Court and of the Referee should be affirmed.

Dated: January 28, 1943.

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